KL CONNECTIONS

WWW.KL-COMMUNICATIONS.COM JUL 22

ECB hiking cycle to pause below 1%

PGIM Fixed Income's Katharine Neiss says sluggish growth will likely force the ECB to pause its hiking cycle below 1% (page 2)

KL CONNECTIONS

Palisade Real Assets acquires Eco2

Palisade Real Assets has acquired Eco2 Management Services Limited (EMSL), a UK-based renewable energy asset management and development company.

The acquisition accelerates Palisade Real Assets' energy transition investment ambitions in UK/Europe and will underpin a dedicated bioenergy platform focused on anaerobic digestion assets and adjacent infrastructure.

The bioenergy platform will own and operate anaerobic digestion assets that capture and convert energy from organic waste into efficient heat, electricity and transport solutions. It will aggregate bioenergy infrastructure assets – in what is currently a fragmented sector – to build a bioenergy enterprise.

EMSL has a team of more than 50 people and a 20+ year track record of managing high-performing renewables assets through concept, development, construction and operation.

Stephen Burns, CEO of Palisade Real Assets, says: "Embedding the asset management and development capability of the EMSL team into the Palisade Real Assets team will help drive high-quality deal flow, enable operational value creation on complex assets that have multiple value propositions, and ultimately deliver better investment returns for our investors."

ECB hiking cycle to end below 1%

Katharine Neiss
PGIM Fixed Income

The European Central Bank (ECB) surprised investors with an outsized 50bp rate hike this month, taking its policy rate out of negative territory in one fell swoop.

The decision to take rates out of negative territory follows on the heels of its June decision to end open-ended asset purchases and marks the end of an era for the ECB – a policy reset that, in our view, is warranted.

However, the ECB's Governing Council underwhelmed with its vague announcement of a new tool, known as the Transmission Protection Instrument (TPI). This tool is meant to ensure the even transmission of monetary policy across the euro area.

Our concern is that, as the ECB raises interest rates, these rises are magnified in some countries – such as Italy. In the extreme, uneven rises could threaten a euro area breakup. The ECB will want to guard against this, but it needs a credible instrument.

"In the extreme, uneven rises could threaten a euro area breakup"

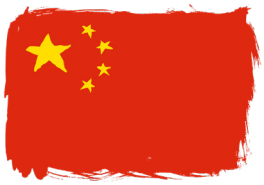
The euro area's energy crisis is becoming more acute by the day, so the ECB's outsized move probably reflects its view the window for rate hikes is narrowing. Moreover, the Governing Council's unanimous approval of the TPI facilitated the aggressive move out of negative territory. Following the Federal Reserve's playbook with a surprise outsized hike gives the ECB cover for abandoning its guidance of just a few weeks ago.

That said, President Christine Lagarde was clear in her press conference: the accelerated pace of tightening does not signal a change in the destination of rates, as the ECB progressively moves towards neutral. The ECB has yet to decide, however, what the neutral rate may be.

Our view remains that growth in the euro area will be challenged, limiting the extent to which the ECB can raise interest rates. We expect GDP growth in 2023 of 1.3%, with significant risks to the downside. A wave of factors is pushing down on the region's outlook. This includes the slowdown in global growth, and significantly higher energy prices.

All this suggests the ECB will need to pause its rate hiking cycle below 1%. If the ECB's rate hikes take its policy rate well above 1%, it will likely need to reverse them as the energy crunch impacts the real economy.

Confidence in China continues



Jacob Mitchell
Antipodes

Certain parts of the Chinese market – like the property and tech sectors – are going through significant regulatory changes and the economy has slowed substantially.

In the short term, things appear to be going in the wrong direction. However, if you take a medium or longer-term approach, the opportunities in China have not changed. The regulatory environment will normalise, because the government is very focused now on economic downside risk and it wants platform companies to start reinvesting and hiring, rather than firing.

Our aim is to find resilient businesses trading at attractive valuations. When you factor in the higher discount rates that are applied to Chinese companies, simply because they are in China, a lot are still attractive.

"If you take a medium or longer-term approach, the opportunities have not changed"

Justin Thomson
T. Rowe Price

Caution over investing in China is higher than it has been in decades – and not without reason.

An uncertain regulatory environment, concerns over the country's strict Covid-19 regulations, and growing geopolitical tensions have left many foreign investors feeling jittery about putting money into the country. However, despite China's apparent lurch towards authoritarianism, the authorities will not allow the 'common prosperity' programme to derail the economy.

Although China may be going through an extended regulatory cycle, it is just that – a cycle. We believe China in five years' time should be more investor friendly than it is today. In the nearer term, a key factor in China's favour is it remains an outlier in a world of surging inflation.

"In five years' time, China should be more investor friendly than it is today"

Charles Walsh
Mirabaud

Even before the impact to growth from the Russia/Ukraine conflict and its Covid lockdowns, China's policy had shifted to an expansionary mode.

This shift has now become more pronounced, to counter the effects of the events in 2022. China has reduced base rates, lowered the reserve ratios of its commercial banks, and is encouraging local governments to raise full funding for infrastructure projects. Also, many targeted measures have been introduced to aid areas such as housing and consumption.

China has also been making encouraging statements in terms of supportive regulation for companies. This is a notable shift – particularly given the crackdowns in many sectors during 2021 – and could turn regulation from a headwind to a tailwind for Chinese companies.

"Regulation could turn from a headwind to a tailwind for Chinese companies"

Evenlode reveals positive carbon emissions data

Evenlode Investment's third annual portfolio emissions report has revealed its portfolio emissions were significantly lower than the MSCI World Index and the FTSE All-Share Index and highlighted a steady increase in scope 3 reporting by investee companies.

The independent Oxfordshire-based asset manager continues to refine the methodology of its portfolio emissions analysis and align it even closer to the PCAF Standard. For the first time, the 2022 report included two recently launched funds – the Evenlode Global Equity Fund and the Evenlode Global Opportunities Fund.

Charlie Freitag, stewardship analyst at Evenlode, comments: "We assess the financed emissions embedded in our investments to better understand the impact our companies have on the climate, and the risks they face from regulation and the transition to a low-carbon economy.

"The analysis also helps us identify the highest-emitting companies in our portfolio and prioritise engagement. Following engagement with all holdings reporting under 90% of scope 1, 2 and 3 emissions in 2021, this year we will engage with all companies in sectors with material climate risk that do not already have science-based 1.5°C-aligned climate transition plans."

Impact investors seeing change

Hari Balkrishna
T. Rowe Price

"Companies are innovating in response to society's demands"

Society has endured a tumultuous period over the last two years – with a pandemic, heightened economic uncertainty, and military conflict in Europe. These events have caused deep loss and upheaval to the daily lives of individuals, families, and communities around the world.

However, amid the uncertainty, we see cause for optimism. The challenges of our era have created open and broad debate about the rights and freedoms of humankind, the growth in inequality, and the clear and obvious pressures on our environment.

To this point, rarely have society and investors mobilised in the way we have seen in the past two years, with clear and raised expectations as to how businesses should conduct themselves in the context of the societies and the environments in which they operate. Companies are innovating in response to society's demands for solutions to pressing issues, and industry leaders are adapting in recognition of their responsibilities.

Impact investing has become a vital tool for investors seeking to contribute to better social and environmental outcomes. This has created an increasing number of opportunities to access positive impact in public equity markets. This backdrop creates real potential for impact investing within a dual mandate that seeks positive environmental and/or social impact alongside excess financial returns.

One company displaying positive impact is NextEra Energy. With nearly $100bn in clean energy infrastructure deployed since 2011, NextEra is the largest US renewable energy generator. As energy generation is responsible for 73% of global GHG emissions, decarbonising the sector is essential to limiting temperature rises to 1.5°C.

Differentiation delivers for duo at Gresham House

The LF Gresham House UK Multi Cap Income Fund marked its five-year anniversary by sitting at the top of the IA UK Equity Income sector since launch.

The £280m fund is managed by Ken Wotton and Brendan Gulston, who employ a private equity approach to public markets, utilising proprietary research and an extensive network of industry and sector specialists to assist in the identification of compelling opportunities in under-researched areas of the UK market.

Since launch, the fund has returned 52%, compared to the IA sector average of 12%. At a time of outflows for many UK equity funds, the fund is also the second-best-selling fund in the sector over the last six months.

Wotton comments: "Despite encountering numerous significant challenges over the past five years, we have never wavered in our belief the UK market offers an array of vibrant and innovative small and mid-cap businesses.

"No matter what market environment we may encounter over the next five years, our investors can count on us to stay true to our philosophy of aiming to target resilient high-quality companies with strong management teams, sustainable market positions and healthy balance sheets."

Vincent Ropers
Wise

Exploiting IT discounts

Market participants like to focus on milestones. While some can appear arbitrary, they are worth mentioning because of their impact on the collective psyche.

In May, the S&P 500 entered a bear market, recalling bad memories from previous occasions – such as the financial crisis and the dotcom bubble.

Given the current macro uncertainty and the high degree of volatility, investment trusts – an area we specialise in – tend to experience widening discounts.

Those movements can be frustrating, particularly when the underlying portfolios are performing well. This is particularly the case with our alternative investments, such as private equity. However, panic-driven wider discounts tend to be short-lived and can present buying opportunities. For example, Oakley Capital Investments saw its discount widen by about 20%, despite strong results reported in April.

Similarly, Caledonia Investments is trading at a deeper discount, despite delivering solid performance and offering a special dividend. While these factors should put it on the radar of investors and help narrow its discount, patience is required in the current environment.

The outlook is complicated due to a confluence of macro challenges. However, it is in these very conditions patient active allocators can unearth long-term alpha.

"Panic-driven wider discounts tend to be short-lived"

Andrew Lake
Mirabaud

The bond opportunity

We are positive on fixed income and believe we are at the beginning of a new fixed income cycle. It is at these times of extreme negativity that opportunities arise.

Having said this, we do have some short-term headwinds. It is summer, and liquidity is poor. Economic numbers in the second quarter may disappoint, and this could lead us back to fears of recession again.

For the market to rally, we need to see investors coming back into the asset class, and this is going to be dependent upon more clarity on where we go from here. This will take a few months to work through.

Therefore, we are cautious over the very near term and have hedged our global fixed income strategies for both duration and credit risk.

This is slightly counterintuitive, but I do think the stagflation argument is a short-term risk for the next couple of months. Rates in the US will continue to go up, and credit is also likely to be under pressure.

For our broad-based global fixed income strategies at Mirabaud, we have been buying longer duration AA and A bonds in the US. We continue to believe there is a huge opportunity once we begin to see inflation numbers in the US decline, and a less aggressive path of interest rate increases. In addition, we continue to be cautious on Europe for now, given the energy situation.

"We have been buying longer duration AA/A debt in the US"

The MiFID II revolution is here

Christophe Girondel
Nordea

"The current focus on greenwashing is only going to intensify in the months and years ahead"

In order to meet the EU's climate change commitments made under the Paris Agreement, regulators have been rolling out a raft of new initiatives to improve disclosure levels and overall investor understanding of sustainable investments.

For example, regulators implemented the Sustainable Finance Disclosure Regulation (SFDR) last year, requiring financial market participants to disclose relevant information related to the sustainability of products and processes.

While SFDR was a major step forward in terms of labelling and disclosures in relation to investment vehicles, it was merely the tip of the regulatory iceberg. The next major stop on the regulatory journey for the investment community is an extension to MiFID II, coming into effect on 2 August. Among a host of MiFID II requirements is one major change for advisers – the need to incorporate sustainability preferences in the overall client suitability assessment.

While determining client sustainability preferences is something some advisers are currently choosing to do, it will soon become something everyone must do.

Even though some advisers may still be grappling with SFDR fund classifications, the expanded MiFID II regime goes far beyond current SFDR categorisation – which will undoubtedly heighten complexity in the months ahead.

While all funds classified as Article 9 under SFDR are expected to be MiFID-eligible, not all Article 8 funds will be. There are additional criteria managers of investment products must meet, which is likely why we have recently seen numerous instances of fund classification changes in recent months across the industry.

Advisers have a lot of choices ahead. Firstly, they must choose whether they will operate a sustainability product offering alongside a more traditional range, or simply transition to a sustainable suite of strategies. They will also need to determine where the bar is set in terms of the sustainability products they select. This is a careful consideration, particularly as the current focus on greenwashing is only going to intensify in the months and years ahead.

Continued demand for sustainable solutions represents a massive opportunity for advisers already well along the business model transition path. However, there will be many intermediaries daunted by the ever-evolving regulatory maze. Therefore, it is imperative our industry works with advisory groups of all sizes to educate workforces.

While all of our Article 8 and 9 funds – which represent 66% of our total AUM – will qualify as suitable for clients with sustainable preferences once the new MiFID II eligibility requirements are in place, advisers cannot assume this will be industry standard.

Even though the asset management community must improve disclosure levels in the post-MiFID world, ultimately the decision about client suitability rests with the adviser.